

JUL 9 1945

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No. 1210

IN THE

Supreme Court of the United States
(OCTOBER TERM, 1945)

P. G. LAKE, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ of Certiorari to the United States
Circuit Court of Appeals For the Fifth Circuit

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vs.

COMMISSIONER OF INTERNAL REVENUE,

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**Petition For Writ of Certiorari to the United States
Circuit Court of Appeals For the Fifth Circuit**

P. G. Lake, Inc., prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above styled and numbered cause on April 17, 1945, affirming a decision of The Tax Court of the United States.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 63) is reported at 148 F. 2d 898. The opinion of the Tax Court (R. 14-21) is reported at 4 T. C. 1.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 17, 1945 (R. 69). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by 43 Stat. 938 (U. S. C. Title 28, Section 347).

QUESTIONS PRESENTED

Does timely constructive receipt of interest by a creditor who was the petitioner's controlling stockholder satisfy the requirement of section 24(c) of the Internal Revenue Code, providing that a debtor making Federal Income Tax Returns on the accrual basis cannot deduct the interest accrued in favor of such a creditor unless "paid within the taxable year or within two and one-half months thereafter"?

Do the provisions of said section apply at all if the interest is actually paid in the year due?

Alternatively, does this statute permit petitioner to deduct the amount actually advanced its creditor on open account before the end of the two and one-half months' period following the year of accrual?

STATUTES INVOLVED

The statutes involved will be found in the Appendix, *infra*. pages 17-19.

STATEMENT OF THE MATTER INVOLVED

In its income tax return for the calendar year 1939, petitioner claimed a deduction for all of the interest which accrued during that year upon its indebtedness to its principal stockholder (R. 16). The Commissioner, relying upon Section 24(c) of the Internal Revenue Code, disallowed this deduction (R. 17). This disallowance was upheld on petitioner's appeal to the Tax Court (R. 14-21), and the Tax Court's decision was affirmed by the Court below (R. 69).

Federal Revenue Acts have always allowed taxpayers, making income tax returns upon an accrual basis,

a deduction for interest upon ordinary debts as such interest accrued by the passage of time, without regard to when the interest was paid. (Sec. 23(b) I. R. C. Appendix, *infra* p. 17). But the creditor, if he reported upon the cash basis, was not required to report such interest until it was actually or constructively received by him. This afforded an opportunity, where the relationship between debtor and creditor was close, to distort and minimize improperly taxable income and tax liability by deliberately delaying or withholding interest payments in such manner as to prevent its correlative taxation to the creditor. The Congress met this situation, in 1937, by enacting what is now Section 24(c) of the Internal Revenue Code (Appendix, *infra*, p. 18). The pertinent Committee Reports are also in the appendix, pp. 19-22, *infra*.

This section, as applicable here, provides that if a creditor owns 50 per cent, or more, of a corporate debtor's stock, no deduction for interest accrued in favor of such creditor shall be allowed, if (1) the interest was not "paid within the taxable year or within two and one-half months after the close thereof;" and (2) the accounting method of the creditor did not require him to include the interest, unless paid, in his gross income for the period "in which or with which the taxable year of the taxpayer ends." The section, in terms, applies to all expenses deductible under section 23(a) and all interest deductible under section 23(b) of the Code. (See Appendix, p. 17 *infra*).

In this case the interest accrued during 1939, and was payable January 1, 1940 (R. 16). Petitioner, admitting that its creditor was also its controlling stock-

holder, claimed that the interest which accrued in 1939 was an allowable deduction for that year because constructively received by and constructively paid to the creditor on January 1, 1940, when it was due; and that this constituted payment within "two and one-half months after the close" of its taxable year, as the statute required (R. 6). The Court below held squarely that nothing short of actual payment would satisfy the Statute (R. 66).

The basic facts, as found by the Tax Court, are:

Petitioner, a corporation making its tax returns upon the accrual basis and for calendar year periods (R. 15), was indebted to its president and majority stockholder, P. G. Lake (R. 15). He reported his income for calendar year periods, but upon the cash basis (R. 15). This indebtedness was evidenced by a series of notes, executed in 1936, which matured annually, and which provided for the payment of interest on all outstanding notes on January 1 of each year (R. 15-16). The interest here involved accrued from January 1, 1939, to the close of that year, but was due and payable on January 1, 1940 (R. 16). This interest was accrued and recorded on petitioner's books monthly during 1939 by credits to an "Accrued Interest Payable" account, in which only interest due on this indebtedness was entered (R. 16). Petitioner gave Lake a check for this interest and the principal of one note on May 17, 1940 (R. 16). Lake and wife duly reported this interest as a part of their gross incomes on the community property basis received in 1940 (R. 16).

Petitioner based its claim that all of this interest was constructively received on January 1, 1940, by Lake, its creditor, on these undisputed facts:

1. Lake, as petitioner's president, was fully authorized to draw checks on its bank account for all proper corporate purposes. No counter-signature was required (R. 17).

2. Petitioner's obligation to pay the interest when due was absolute, unconditional, and recognized by its accounting records and otherwise (R. 16-17-46).

3. From January 1, 1940, to May 17, 1940, petitioner with (other than for current expenses) no debts save those owing to Lake, had free and unencumbered bank balances at no time less than \$306,548.05, while the interest and matured note due January 1, 1940, amounted to \$156,000.00, so that Lake could have on January 1, 1940, or at any time thereafter, collected the interest merely by writing a check therefor (R. 16-17).

Petitioner also contended, in the Tax Court and in the Court below, that the phrase in Section 24(c)(1) "within the taxable year or within two and one-half months after the close thereof" had reference to the year in which the interest was due, rather than the year in which the interest accrued, so that actual payment on May 17, 1940, of the interest due January 1, 1940, constituted a full compliance with the statutory requirement. Neither the opinion of the Tax Court, nor that of the Court below, dealt specifically with this question.

Nor did the Court below deal with petitioner's alternate contention, likewise duly presented to both Courts (R. 6-16-20-29), that the amount due on open account to petitioner by its creditor, Lake, on March 15, 1940, should be treated as a payment upon the 1939 interest within two and one-half months from the close of that year. This balance was \$32,226.89 (R. 16), and, under the undisputed facts and findings, arose in this way: On January 1, 1940, Lake was indebted to petitioner for earlier drawings in the sum of \$672.09. Between that date and March 15, 1940, petitioner made disbursements for the account of Lake which increased this balance to \$32,226.89 (R. 16). By May 17, 1940, this balance had increased to \$55,815.20 (R. 17). On that date, petitioner issued its check to Lake and he gave petitioner his check for the amount shown by the open account (R. 17). The Tax Court made no finding to that effect, but the undisputed testimony showed that this method of settling the mutual debts by check rather than by offset was followed so that Lake would have in his bank account all data necessary for his individual tax return (R. 42).

SPECIFICATION OF ERRORS TO BE URGED

The following errors in the decision below are specified by petitioner:

1. The Court below erred in holding that constructive receipt of interest by the creditor (Lake, the majority stockholder) within two and one-half months from the close of the taxable year in which the interest accrued (1939) did not require that the

interest be allowed petitioner as a deduction from gross income for the year of accrual.

2. The Court below erred in failing to hold, as a matter of law under the facts found by the Tax Court, that Lake, the creditor, constructively received the interest owing him by petitioner, and accrued in his favor during 1939, on January 1, 1940, when it was due.

3. The Court below erred in failing to hold that the disbursements made by petitioner for the account of Lake, its creditor, prior to March 15, 1940, were payments of an equivalent amount of the interest accrued in Lake's favor during 1939, and due January 1, 1940, so that so much of this interest was deductible by petitioner in computing its 1939 income.

4. The Court below erred in failing to hold that payment by petitioner of the interest (accrued in favor of its majority stockholder during 1939) at any time during the year 1940 (the year it became due and payable) met the requirements of Section 24(c) of the Internal Revenue Code, and required the allowance of the 1939 accrued interest as a deduction from 1939 gross income.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

The writ of certiorari sought hereby should be allowed because:

I.

The decision below conflicts with a decision of the United States Circuit Court of Appeals for the Sixth

Circuit on the same matter in *Musselman Hub-Brake Company v. Commissioner of Internal Revenue*, 139 F. 2d 65.

In that case, the Sixth Circuit Court reversed a decision of the Tax Court which had held that royalties and interest accrued in favor of a controlling stockholder, during 1937, 1938 and 1939, were not deductible because of Section 24(c) of the applicable Acts, for the reason that they were not paid in cash within two and one-half months after the close of the respective years of accrual. In so doing, the Sixth Circuit Court held (139 F. 2d at p. 68):

" * * it would seem that Congress meant that the debts were paid when the deductions constituted income actually or constructively received by the creditor. In other words, if the debtor credited to the account of the creditor sums under circumstances which would require reporting income constructively received or the creditor received property, either tangible or intangible, having a cash value equal to the deduction claimed by the debtor, the deduction would be allowable under the statute, because the creditor would be required to include these sums in his gross income."*

(Emphasis supplied.)

In direct conflict with this, the Court below held that:

"Where, as here, the definite word 'paid' is used in the statute we are not permitted by the theory of fiction to give that word an indefinite meaning as taxpayer would have us do by en-

*grafting on the statute the word 'constructively' (R. 66). * * * * **

(Emphasis supplied.)

Likewise, the Sixth Circuit held (139 F. 2d at p. 68):

"To construe the word 'paid' to mean that the payment must be in cash, is to distort the statute;"

but the Court below held:

"The ordinary and usual meaning of 'paid' is to liquidate a liability in cash." (R. 66).

Again, the Sixth Circuit said (139 F. 2d at p. 67):

"We are not here concerned with the rule that deductions are a matter of legislative grace and therefore the taxpayer must bring a claimed deduction clearly within the terms of the statute, because the statutes we are considering all relate to deductions. When Section 23 is applied, the deductions in question are clearly allowable, but for Section 24 (c). So, the rule applies that the two sections should be integrated to carry into effect their combined purpose."

but the Court below said:

"For taxpayer to come within the legislative grace granted by Congress and to claim and secure the deduction, it must bring its case within the terms of the statute as written." (R. 66).

That the conflict in the two opinions is irreconcilable, even though the Court below did not cite or refer

to the opinion of the Sixth Circuit,¹ is emphasized by the fact the opinions of this Court cited and primarily relied upon by the Court below (*Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269; *Helvering v. Price*, 309 U. S. 409; and *Eckert v. Burnet*, 283 U. S. 140) were fully discussed and convincingly distinguished in the opinion of the Sixth Circuit Court in the *Musselman* case. Likewise, each Court cited the legislative history of section 24(c),² the Sixth Circuit, to support its conclusions that sections 23(a) and (b) and 24(c) "should be integrated to carry into effect their combined purpose;" the Court below, merely to support the statement that section 24(c) was designed "to prevent tax avoidance and tax evasion" without attempting to show that its holding prevented, or tended to prevent, either.³

That the two Circuit Courts have given exactly opposite answers to every question pertinent to the decisions reached is further demonstrated by the following summary of these questions and the respective answers made:

¹Petitioner knows of no explanation for this. Below, the petitioner cited and largely relied upon the *Musselman* case; the respondent attempted to distinguish it in his brief, and, at argument, admitted that the statements in that case, which petitioner relied upon, conflicted with his position in the case at bar.

²The committee reports are in the Appendix hereto, pp. 19 to 22, *infra*.

³There was no tax avoidance or evasion in this case. Lake reported the interest just as he would have done had it been physically paid in cash on January 1, 1940, when due. (R. 16).

1. Does constructive receipt of interest by the creditor within the time fixed by the statute entitle the debtor to deduct the interest? Yes (Sixth Circuit). No. (Fifth Circuit).

2. Does the word "paid" in Section 24(c)(1), *supra*, require a cash payment? No (Sixth Circuit). Yes (Fifth Circuit).

3. Does the rule that deductions are a matter of legislative grace and are to be strictly construed apply in construing Section 24(c)? No (Sixth Circuit). Yes (Fifth Circuit).

4. Do the decisions of this Court in *Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269; *Helvering v. Price*, 309 U. S. 409; and *Eckert v. Burnet*, 283 U. S. 140 require that the interest deduction claimed be disallowed? Yes (Fifth Circuit). No (Sixth Circuit).

5. Does the legislative history of section 24(c) require such disallowance? No (Sixth Circuit). Yes (Fifth Circuit).

II.

The Court below decided (and, we submit, incorrectly decided) an important question of Federal law which has not been, but should be, settled by this Court.

The general question is the construction and application of section 24(c) of the Internal Revenue Code, and the corresponding sections of earlier Acts. The specific point decided below was that only an actual

cash payment within the statutory period satisfied the requirement of the section that the expense or interest be paid within the tax year, or within two and one-half months thereafter.

This Court has never been called upon to construe or apply this statute.

The importance of the question is evidenced by the fact that, since 1941, the Tax Court has delivered at least twenty-eight opinions directly involving the construction and application of the section. These cases are listed in the Appendix, p. 24 *infra*. Six of these cases have been decided thus far in 1945. Six of the twenty-eight have reached the Circuit Courts; the case at bar (148 F. 2d 898), the *Musselman* case, *supra*; *Cheltenham, etc. Company v. Commissioner*, 131 F. 2d 863 (C. C. A. 3, 1942); *Lenox Clothes Shop, Inc. v. Commissioner*, 139 F. 2d 56 (C. C. A. 6, 1943); *Celina Mfg. Company v. Commissioner*, 142 F. 2d 449 (C. C. A. 6, 1944); *Mansuss Realty Company, Inc., v. Commissioner*, 143 F. 2d 286 (C. C. A. 2, 1944). Four of these (the *Musselman*, *Lenox*, *Celina* and the case at bar) directly involved the construction and application of section 24(c)(1), and only in the case at bar was the Tax Court affirmed.

Petitioner is without information as to the number of cases involving the section pending in the Bureau or filed in, but not yet decided by, the Tax Court; but the number of decided cases indicates that there are many times more so pending.

That these cases will give rise to further conflicts which will require action by this Court, unless the

matter is set at rest by reviewing this case, is indicated by the course of these decisions. Thus, the Tax Court is committed to the proposition that constructive receipt satisfies the requirements of section 24(c) (2), *Michael Flynn Mfg. Company*, 3 T. C. 932 (1944). By its decision in the case at bar, that Court seemed committed to the proposition that constructive receipt does not satisfy section 24(c) (1); but a subsequent opinion (*Nock Fire Brick Company*, entered April 21, 1945, C. C. H. Dec. 14,527 (M) held that salaries constructively, but not actually, received were deductible under section 24(c) (1); and this despite the fact that the statute makes no distinction between salaries and interest.⁴ The Tax Court refused to apply the *Musselman* case in deciding the case at bar, but after it had been affirmed by the Court below, it cited and applied the *Musselman* case as establishing that deductions are paid "within section (24(c) (1) if the recipient is chargeable with receiving income though such payments are not made in cash." *Lectrolite Corporation*, entered April 20, 1945, C. C. H. Decision 14,530 (M).

Further in the case at bar the Tax Court and the Court below applied the section with the greatest strictness and without considering whether such a construction was necessary to accomplish the Congressional purpose of preventing tax avoidance; although, in subsequent cases just cited, the Tax Court has applied a more liberal rule. Thus, in the present case,

⁴It was on this basis that the Tax Court in the *Nock Fire Brick Company* decision attempted to distinguish its decision in the case at bar.

where there was no attempt to avoid, or possibility of avoiding, a tax liability, a construction was adopted which will cause petitioner to lose entirely a deduction for interest actually accrued on a bona fide debt. Being on the accrual basis, petitioner cannot take the deduction in the year the interest was actually paid. *Cf. Miller & Vidor Lumber Company v. Commissioner*, 39 F. 2d 890 (C. C. A. 5, 1930). "Even tax administration does not as a matter of principle preclude considerations of fairness." *Angelus Milling Company v. Commissioner*, U. S. (May 21, 1945) 65 S. Ct. 1162-65. This unnecessary and improper harshness will certainly produce controversy and conflicts until the question of the section's proper application and construction is decided by this Court.

The holding by the Court below that it was "not permitted" to construe the word "paid" to mean "constructively paid" brings into question the whole line of cases, and the attendant questions of departmental practice and statutory construction, involving the doctrine of constructive receipt and payment. No tax statute has ever used the phrase "constructive receipt." Yet the Regulations have always required taxpayers on the cash basis to report income when constructively, though not actually, received by them. See, for example, Regulations 103, Sec. 19.42-2, Appendix, p. 22, *infra*. This Regulation has been upheld by many Courts, including the Court below. *A. D. Saenger, Inc. v. Commissioner*, 84 F. 2d 23 (C. C. A. 5, 1936); *Loose v. United States*, 74 F. 2d 147 (C. C. A.

8, 1934); *Hadley v. Commissioner*, 36 F. 2d 543 (App. D. C. 1929); *Schoenheit et al. v. Lucas*, 44 F. 2d 476 (C. C. A. 4, 1930); and *Commissioner v. Scatena*, 85 F. 2d 729 (C. C. A. 9, 1936). See, also, *Corliss v. Bowers*, 281 U. S. 376. As to constructive payment, the Tax Court has held, properly construing the statute to accomplish the Congressional purpose, that dividends are paid by a corporation, within the statute providing a credit for dividends "paid" in computing income subject to the tax on undistributed profits (Sec. 27(b)(1), Internal Revenue Code), when constructively received by the shareholder. The Commissioner has acquiesced in this holding. *The Atlantic Land Company*, 43 B. T. A. 74 (1940); *Valley Lumber Company of Lodi*, 43 B. T. A. 423 (1941); *R. H. Bouligny, Inc.*, 45 B. T. A. 456 (1941), Acq. 1942-1 C. B. 3. The basic purpose of this statutory provision allowing a credit for dividends paid, as well as section 24(c) here involved, was to correlate inclusion in income by the payee with deductibility from income by the payor. This purpose is completely accomplished when the statute restricting deductions for accrued expenses and interest is applied so that the payor will be allowed to deduct all of these items which the payee is required to include in income for the year of accrual or within two and one-half months thereafter. No such purpose underlay the statute dealt with by this Court in *Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269, chiefly relied on by the Court below; instead this Court there only refused to permit a taxpayer, reporting on the cash basis, to deduct interest accrued but unpaid, and in so doing

emphasized the importance of correlating income with deductions by pointing out that the interest in question was not reported by the payees, nor required to be reported by them under the doctrine of constructive receipt.⁵

A provision of the type of section 24(c) is necessary for the orderly and equitable administration of the Revenue Laws. Its continuation in the Revenue Code is desirable and is to be expected. It is highly important, therefore, that the principles governing its construction and application be settled by this Court as speedily as possible. The problem is wholly one of statutory construction for this Court's "independent judgment." *Commissioner v. Bedford's Estate*, U. S., 65 S. Ct. 1157-1161.

Wherefore, petitioner respectfully prays that this petition for a writ of certiorari be granted.

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⁵*Helvering v. Price*, 309 U. S. 409, and *Eckert v. Burnet*, 283 U. S. 140, were cited below but these cases only deal with the time when bad debt losses are sustained by a taxpayer on the cash basis of accounting; not with constructive payment and receipt.

